Summary of Testimony of
Commissioner Linda Breathitt
Federal Energy Regulatory Commission
before the
Subcommittee on Energy and Air Quality
Committee on Energy and Commerce
United States House of Representatives
March 20, 2001

We must recognize that the solutions to the market disruptions and price volatility in California and Western energy markets will be as multi-faceted as the causes, and prepare ourselves to make the tough decisions necessary to resolve the problems. We must place all available options on the table. Still, I believe that competitive wholesale bulk power markets are attainable and that legislators and regulators should stay the course.

Many factors contributed to the California market problems: high production costs and increased demand; scarcity of generation; exposure of the three investor-owned utilities (IOUs) to the volatility of the spot market without the ability to hedge in forward markets; underscheduling of demand and supply; and unplanned power plant outages. It is becoming increasingly apparent that the causes of the California energy crisis are not only state-specific, but regional in nature.

The Commission has taken decisive actions in several recent orders establishing remedies for the California market; launching an investigation of California marketers and their actions that inflated electric prices in California; establishing a conference to discuss price volatility issues with Western state commissioners; implementing or proposing a number of initiatives to remove obstacles to natural gas and electricity supply in the West; and requiring certain sellers in the California market to either make refunds totaling $69 million for January 2001 and $55 million for February 2001, or provide additional cost justification.

Going forward, I believe that FERC may need to have a greater role in the siting of new infrastructure because shortages of generation and transmission will no longer be single-state issues. I further view the formation of RTOs in the West as important for the expansion and enhancement of the transmission grid. To address volatile natural gas prices, I would urge California regulators to limit the incentive for natural gas purchasers to gravitate to the spot market. The Commission will continue to do its part to get adequate pipeline infrastructure to California, but California needs to assess whether there is sufficient intrastate capacity to take gas from the border to the market. Finally, I support the Commission's initiative to explore the feasibility of easing certain operating constraints for jurisdictional hydroelectric projects where we can do so without compromising important environmental resources.

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Mr. Chairman and Members of the Subcommittee:

I appreciate this opportunity to appear before you today to discuss the energy crisis in California and the worsening conditions of electric systems and markets elsewhere in the Western United States. I believe it is not only appropriate, but necessary, that we meet at this time to examine a crisis that is affecting the lives and well-being of millions of citizens and threatening the very existence of thousands of commercial enterprises throughout the West.

The magnitude of this growing crisis, and its potential disruptive capability, cannot be overestimated. The extraordinarily high prices for electricity and the extreme shortages of supply are creating a consumer backlash against newly restructured electricity markets. Unfortunately, the move toward a competitive electricity marketplace will undoubtedly be affected by this crisis and could even be suspended if other states, fearful of what they are seeing in the West, terminate their restructuring efforts. For these reasons, I welcome the interest and involvement of Congress in this matter and I look forward to working with you to address these problems.

For many months, the Federal Energy Regulatory Commission has been grappling with and attempting to resolve the California energy crisis. We are now taking specific action, as well, to address problems in other parts of the West. I believe our actions to date have been significant and appropriate and will improve the long-term situation in the Western electricity markets. I am becoming increasingly concerned, however, about the near-term problem, particularly what will happen this summer in California. The predictions I am hearing for prolonged blackouts, supply shortages and even higher prices are alarming, to say the least.

I am very concerned that, even as important as they are, our actions to date, and those of California officials, will not improve the immediate and near-term situation in California. We may have to explore other short-term remedies to stem the damaging disruptions in these markets. Indeed, over the past several weeks we have received letters from members of the California Congressional Delegation, governors of some Western states, and others urging immediate, short-term action by the Commission, including the imposition of regional price caps, to restrain the high wholesale costs of electricity in the region. I believe it is imperative that the Commission place all available options on the table for consideration. The solutions to these problems will be as multi-faceted and complex as the causes. We must recognize that fact and prepare ourselves to make the tough decisions necessary to resolve the problems.

My testimony today will build on that theme by discussing some of the apparent causes of the disruptions in Western electricity markets, some of our important actions intended to relieve these disruptions, and, what I believe to be, the appropriate role of the Commission in addressing the volatilities and uncertainties that exist in these markets. I will also briefly discuss recent actions taken by California officials. In addition, I adopt the attachment to Chairman Hébert's testimony which provides a description and summary of several important orders issued by the Commission over the past five years regarding California's restructuring plan and electricity markets. This summary was prepared by Commission Staff and I believe it will provide you with a sufficient framework for understanding the chronology and details of FERC's key decisions and actions addressing California's restructuring efforts, some of which were issued before I began my tenure on the Commission.

The Commission has focused much of its attention over the past several months in defining and understanding the causes of the market disruptions and high electricity prices in California and throughout the West. As expected, we found that multiple factors contributed to the situation. A Commission Staff report completed in November 2000 found, among other things that: (1) market forces in the form of significantly increased power production costs combined with increased demand due to unusually high temperatures to create unstable conditions in the West; (2) scarcity of available generation resources throughout the Western region played a significant role; (3) existing market rules worsened the tight supply-demand conditions by exposing the three investor-owned utilities in California to the volatility of the spot energy market without affording them the opportunity to mitigate price volatility by hedging their positions in forward electricity markets; (4) an underscheduling of demand and supply in the California Power

Exchange's day-ahead and hour-ahead markets increased the activity in the more volatile real-time spot market operated by the California Independent System Operator (ISO); and (5) unplanned outages of power plants increased significantly during the summer of 2000.

It is becoming increasingly apparent that the causes of the California energy crisis are not only state-specific, but are also regional in nature. In other words, to fully understand the problems in California, it is necessary to look at conditions in the entire Western Interconnection. California has historically relied on imports to supply 15 to 20 percent of its capacity needs during summer peak periods, primarily from hydroelectric plants in the Northwest. Due to increased demand elsewhere in the West and low water levels in hydroelectric reservoirs in the Northwest, available imports into California in 2000 were less than half what they were in 1999. As a result, the California ISO had approximately 3,000 MW less generating capacity available from outside the state in 2000 than in 1999. This is but one example of the regional nature of the problem in the West.

I believe the Commission has taken bold and decisive actions, within its jurisdiction, to remedy the extreme distortions in the California markets and to address instances of potential market power abuses. First, on December 15, 2000, we issued a major order establishing a set of remedies for the California market. In an effort to significantly reduce California's exposure to the volatile spot market, we eliminated the requirement set by the California legislation that the investor-owned utilities sell all of their generation into, and buy all of their power needs from the California Power Exchange. In effect, this action immediately returned 25,000 MWs to State regulation. This should allow the IOUs to move their purchase power needs to long-term bilateral contracts and to adopt a balanced portfolio of contracts to mitigate cost exposure. We also adopted a benchmark price of $74 per megawatt-hour for assessing prices of long-term electric supply contracts. In an effort to reduce the real-time spot market to only about 5 percent of peak load, we initiated a penalty charge that would be imposed on any market participants that under schedules load in day-ahead and other forward markets.

To ensure that prices in the ISO and PX spot markets are just and reasonable, the Commission established an interim breakpoint mechanism for sellers bidding into the spot market. Sellers bidding at or below $150 per megawatt will receive the market clearing price. Sellers bidding above that level will receive their actual bids, but the bid will not set the market clearing price. In addition, these bidders will be subject to certain reporting requirements and monitoring. Bids above $150 are subject to refund pursuant to Section 206 of the Federal Power Act. This breakpoint mechanism will be replaced on May 1 by a permanent and comprehensive market monitoring and mitigation program which will screen for market abuses.

On March 9, 2001, we issued an Order directing certain sellers into the California market to either provide refunds totaling $69 million dollars in excessive charges for electricity during January 2001 or supply further cost or other justification for prices charges above a proxy market clearing price established in the order. Similarly, on

March 16, 2001, we ordered potential refunds totaling $55 million dollars in excessive charges for electricity during February 2001. These Orders directing potential refunds are pursuant to our December 15, 2000 order establishing remedies for the California's wholesale electric markets.

Last Wednesday, March 14, 2001, the Commission launched an investigation of two California power marketers, Williams Energy Market & Trading Company and AES Southland, Inc., and issued a Show Cause Order directing the companies to explain why they should not be found to have violated the Federal Power Act by engaging in actions that inflated electric prices in the California market and potentially compromising the reliability of the transmission network. If these companies are found to have violated the terms and conditions of filed tariffs, the Commission could direct the companies to return profits, in excess of $10.8 million, and condition the companies' future market-based rate authority.

Also on March 14, 2001, the Commission issued an order announcing certain actions that we will take or propose to take to increase the supply of electricity in the West. Our order examined both electric supply-side and demand-side actions that could be taken, and how best to assure the input of natural gas needed for electric power production. We acknowledge that our authority is somewhat limited, but the steps we plan or propose to take should help increase supply from existing power sources and could provide regulatory incentives to build new electric and natural gas infrastructure.

From my perspective, two aspects of the order are especially worth noting. First, the order establishes a conference in which FERC Commissioners will meet with Western state commissioners to hear their views on how FERC can assist them in addressing the market disruptions in the West. This type of interaction and coordination is important since state regulators, not the FERC, presently have siting authority for electric generation and transmission facilities. Moreover, state regulators have the most significant authorities to encourage demand reduction measures. I look forward especially to seek state commissioners' advice on what the Commission can do with respect to price volatility in the region. Although our March 14 order does not focus specifically on the volatile wholesale prices in the West, I believe that FERC has to examine all its options in that aspect of the electricity markets as well. I will urge my state colleagues to be forthcoming and candid with us as we examine together the extreme price volatility in these markets and implementation issues associated with any additional actions.

Second, our March 14 order supports and addresses the requests made by California Governor Gray Davis and Secretary of Energy Spencer Abraham for the Commission to extend our waivers of certain regulations for Qualifying Facilities. In our order, we extended through December 31, 2001, our temporary waiver of operating and efficiency standards and fuel use requirements for QFs, in order to allow them to increase their generation. In addition, we found good cause to apply those waivers to the entire Western System Coordinating Council (WSCC). In so doing, we require that all additional output from those QFs be sold exclusively through negotiated bilateral contracts at market-based rates. This should benefit all parties and help serve load in the WSCC at a time when generation resources are inadequate.

As I have stated, the Commission has taken important steps in these orders to address the market disruptions in California and the West. If these steps prove to be unsuccessful, the Commission must act quickly to establish alternative remedies. As I have stated publicly on recent occasions, I am maintaining an open mind and a willingness to implement the structural or regulatory remedies that are required. We must strive to stabilize the markets in the West before the summer peak period begins and before the California market imperfections further worsen the market problems that are already developing in the Northwest and elsewhere in the Western Interconnection.

As we continue to monitor the situation in the West, the Commission will continue to examine its role in these matters and to take appropriate action when necessary. One important aspect of the electricity system in the West and elsewhere in the country in which the Commission's jurisdictional role is restricted as it pertains to the siting of new transmission and generation facilities. Currently, under the Federal Power Act, the Commission has no role in the permitting and siting of these new facilities. I am beginning to believe this may need to be changed. FERC may need to have a greater role in the siting of new infrastructure, because shortages of generation and transmission likely will no longer be just single state issues. I believe these shortages could become interstate commerce issues that must be addressed by the Federal government.

Already we are seeing how a shortage of electric infrastructure in California can affect prices and the efficient operation of the interstate transmission grid. We've recognized that California is experiencing a shortage of generation capacity. But the state's need for new transmission infrastructure is also becoming an important factor affecting the electricity markets. The last major transmission line that was built in California was the California-Oregon Transmission Project in 1993. The California ISO has identified a number of transmission projects that will both increase import capability and improve the reliability of the grid in various parts of the state. In addition, the ISO has identified projects in the San Francisco area that should be constructed in the next 2-3 years. These projects, evidently, would relieve congestion along the major north-south transmission path and improve the overall reliability of the ISO grid. I am concerned that some of these needed projects may not be built. My concern is heightened by delays such as are being experienced by San Diego Gas & Electric's proposed Valley-Rainbow 500 kV Project. Although this project was approved by the California ISO in May 2000, it is being delayed because of local opposition. The ISO has determined that this project or a comparable alternative is needed to reliably serve load growth in San Diego beyond 2003. This is just one example, but I believe that a federal role in transmission siting throughout the country could be helpful in instances such as this, and could, in fact, become necessary in the future.

With regard to transmission upgrade and expansion, I believe the Commission's Order No. 2000, issued in December 1999, will create an important regulatory framework. Order No. 2000 is intended to encourage the formation of Regional

Transmission Organizations throughout the United States. The Order includes a specific functional requirement for RTOs to develop a strategy for transmission planning and expansion. The order also describes innovative pricing options that the Commission would consider for RTOs. Such ratemaking mechanisms could provide necessary incentives for the construction of new or enhanced transmission facilities. I believe the formation of RTOs in the West will be a significant benefit for many aspects of the electric markets in that region, including the expansion and enhancement of the transmission grid.

Due to the continuing convergence of the electric and natural gas industries, problems that have affected the electric utilities in California and the West also have been felt in the natural gas industry. Furthermore, there is a clear nexus between the pressure to capture all megawatts available and the increased use of hydroelectric facilities in the West. I will first address natural gas issues.

I believe that there are both short-term and longer-term actions that need to be taken on the natural gas front. In the short-term, there appears to be an over-reliance on spot-market purchases of natural gas. Our December 15th order found that a major cause of the high electric prices in California was the over-reliance on the spot market for electricity. In that order, the Commission recommended that the IOU's put 95 percent of their load in forward markets to minimize exposure to the price volatility of the spot market. I believe that the same logic holds for the natural gas market.

It is my understanding that the California Public Utilities Commission allows for recovery of gas costs that meet a benchmark determined by the use of monthly spot market purchases. It is my opinion that this policy creates an incentive to rely on spot market purchases of natural gas. Accordingly, I would suggest that policies should be in place that provide an incentive for natural gas buyers to use risk management tools, such as price hedging, to decrease commodity pricing uncertainties.

I strongly believe that regulators need to be careful to discern the difference between hedging to reduce exposure to price volatility, and mere speculating. It may be a fine distinction, but it is one that is critical. Hedging can be a useful tool to decrease uncertainty, while speculating to beat the market can increase the possibility of risk. It could even be said that failing to hedge and, therefore, limit the exposure to the vagaries of the spot market, is actually speculating. Consequently, I would urge regulators in California to look at the benefits that may accrue by limiting the incentive for natural gas purchasers to gravitate toward the spot market.

The Commission's March 14th order on supply and demand issues presented a number of longer term measures that the Commission is taking or may take to increase the amount of interstate natural gas capacity into California and the West. Specifically, the Commission has realigned its staff to be able to respond as quickly as possible to applications for new gas pipeline capacity for the West. Through this order, FERC also is seeking comments on the need to provide rate incentives to expedite construction of projects that will make additional capacity available this summer on constrained pipeline systems.

However, there is another California infrastructure concern that should be resolved at the state level. While FERC has jurisdiction over the siting of interstate natural gas pipelines, the states have siting authority for intrastate facilities. Consequently, FERC can do its part to get adequate pipeline infrastructure to California, the state needs to assess whether there is sufficient intrastate capacity available to take natural gas from the border to market.

The Commission is addressing the need for increased supplies through the administration of its hydro licensing program, as well. With hydropower comprising approximately 40 percent of the total WSCC generation capacity, the Commission has launched an initiative to explore the feasibility of easing certain operating constraints, such as minimum flow and reservoir level requirements, that act to reduce the energy production, peaking capacity, and other power benefits of hydropower projects. These operating constraints serve to protect many resources - such as resident and anadromous fish, water quality, recreation, municipal and industrial water supplies, and agricultural resources. The tension will be in finding a balance between greater operational flexibility and the protection of environmental resources. In addition, a more efficient use of available water resources at licensed projects could contribute to meet the electric capacity and energy needs of the Northwest.

The Commission's goal is to establish a methodology by which the Commission can quickly identify projects where there is a potential for more electricity to be generated with the least effect on resources, and then to create a process by which we can quickly review requests for modifications. The Commission's experience with emergency drought conditions in California in the 1980s provides a general framework for this exercise. The tension in will be in finding a balance between greater operational flexibility and the protection of resources. In order to achieve this objective, it will be necessary to seek the cooperation not only of FERC licensees, but also federal, state, and local resource agencies and other interested parties. In our March 14th Order addressing supply and demand issues, we announced a staff conference, to be held as soon as possible this spring. I will be willing to support greater flexibility in cases where the reliability of the system can be enhanced during this critical time, without compromising important environmental resources.

As I have stated throughout my testimony today, I believe the Commission is taking appropriate and important steps to address the market disruptions in the West. I want to point to some actions that are also being taken by California officials in their efforts to address some of the problems in their state. For instance, Governor Davis has: (1) implemented a limited-term rate reward program for conservation efforts by residential, commercial and industrial customers; (2) expedited the processing of applications for certification for peaking and renewable power plants; (3) provided for performance awards relating to the construction of power plants brought on line prior to

July1, 2001; and (4) modified emissions limits that restrict the hours in which certain plants can operate.

In addition, as noted in Chairman Barton's March 12, 2001, letter inviting me to testify before you today, the state has enacted legislation and regulations facilitating state contracting for power. The state is also considering other options, such as purchasing utility transmission lines. Most of these actions, I believe, will have beneficial long-term effects on California's electricity market. I would like to comment briefly, however, on one of these measures. The possible state purchase of the investor-owned utilities' transmission systems has received a great deal of press coverage and discussion. In my opinion, the issue is not so much who owns the transmission system in California, or elsewhere for that matter. The real issue is that the transmission system, whether public or private, needs to be part of a regional grid. Only independent, regionally operated grids will ensure competitive electricity markets that are open, efficient, reliable, and free from discrimination. As we continue discussing this matter, what's truly important is that California's transmission system remain as much a part of the Western regional grid in the future as it is today.

In conclusion, I believe that competitive and open wholesale bulk power markets are still attainable and should remain the objective of regulators and legislators throughout the country. I remain confident that we can implement appropriate short-term and long-term solutions to current problems so that we can stay the course toward open and competitive markets. Let me again say that I look forward to working with this Subcommittee and others to address these significant issues.